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WESTERN ASSET REMAINS POSITIVE ON ASIAN ECONOMY AND BOND MARKETS DESPITE RECENT INCREASE IN INVESTOR RISK AVERSION

- Economic fundamentals remain strong despite recent correction and higher risk aversion
- Inflation is the main risk to Asian bond markets at present
- Western Asset remains positive on Asian corporate spreads

Singapore – 25 February 2010 – The recent increase in risk aversion has challenged expectations of a slow to moderate recovery in the US and Europe, and sharp, self-sustaining growth in Asia. While many equity markets in the region have corrected by more than 10% and Asian currencies seem to have lost their momentum, however, Western Asset remains constructive on the region.

“We think that fundamentals continue to point to a positive 2010 in the region. Inventory normalization has just begun in the US and Europe, and should continue to boost exports for a few more quarters. Domestic growth in the region has become self-sustainable. Retail sales are increasing across the region. Businesses are increasingly confident: they are investing again and employment is rising,” said Rajeev De Mello, Head of Asian Investment.

Western Asset believes that the current risk to Asian bond markets is higher inflation. So far, inflation seems to be due to domestic non-tradable commodities such as food. However, if policy-makers maintain their ultra-accommodative stance for too long, higher inflation expectations could become more entrenched. Some of food inflation is supply-driven due to abnormal weather such as the poor Indian summer monsoons. In those cases, policy-makers are wary of overreacting since higher interest rates will have no impact on food prices. Another component of food inflation is due to the policy objective of improving rural incomes relative to urban incomes. However, there is some portion of food inflation that may be due to the easy money flowing in to rural areas thanks to easy fiscal and monetary policies.

“So far, it seems that policy-makers are trying to delay monetary tightening moves until they have a clearer understanding of the sources of inflation. This delay will benefit the front end of the yield curve, which is more sensitive to changes in policy and less sensitive to increases in inflation,” said De Mello.

Asian currencies should benefit from further global economic recovery. In many countries, exports continue to recover, allowing policy-makers to tolerate gradual currency appreciation. As inflation creeps up, currency appreciation should also be used as a tool to mitigate imported, commodity-related inflation. Asian currencies should be further boosted by a change in China’s currency policy.

“We remain positive on Asian corporate spreads. The growth environment remains supportive and default rates should continue to remain low as global default rates fall back to more normal levels.” said De Mello.

Asian bonds started the year on a strong note thanks to an early-year rally in Asian currencies. In the second half of January the market shifted away from currencies toward government bonds as risk aversion increased. The reserve requirement increase in China triggered concern about a potential slowdown, while US President Obama’s plan for taxing financial institutions and worries surrounding Greece contributed to an increase in global risk aversion.

Asian local currency bonds, as measured by the HSBC Asian Local Bond Index, returned 0.89% in January. Asian external bonds, as measured by the JPMorgan Asian Credit Index, returned 1.11% during the month thanks to lower US government bond yields. Asian high-yield corporate bonds posted their strongest month in the past three months, returning 3.28%.

Corporate spreads widened due to the increase in risk aversion and concerns about the extent of corporate issuance. Despite market weakness, Asian high-yield issues, especially Indonesian issuers, held up well.

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Note to Editors

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